

Report of the auditor-general to the Eastern Cape Provincial Legislature and the council on Makana Local Municipality

Report on the financial statements

Introduction

1. I have audited the financial statements of the Makana Local Municipality set out on pages ... to ..., which comprise the statement of financial position as at 30 June 2015, the statement of financial performance, statement of changes in net assets, cash flow statement and the statement of comparison of budget information with actual information for the year then ended, as well as the notes, comprising a summary of significant accounting policies and other explanatory information.

Accounting officer's responsibility for the financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and Division of Revenue Act of South Africa, 2013 (Act No. 10 of 2014) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of separate financial statements that are free from material misstatement, whether due to fraud or error

Auditor-general's responsibility

3. My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with International Standards on Auditing. Those standards require that I comply with ethical requirements, and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the municipality's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the municipality's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for Qualified Opinion

Consumer debtors

6. The municipality did not have adequate processes in place to ensure that interest on outstanding amounts from consumers was recognised in the financial statements. As a result consumer debtors as disclosed in note 5 to the financial statements and interest received as disclosed in the statement of financial performance are understated by R5,4 million .
7. In addition, I was unable to obtain sufficient appropriate audit evidence regarding consumer debtors, as the balances were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the balances in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to consumer debtors stated at R174,8 million (2014: R129,6 million) in the statement of financial position and note 5 to the financial statements was necessary.

Receivables from non-exchange transactions

8. I was unable to obtain sufficient appropriate audit evidence regarding receivables from non-exchange transactions, as the balances were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the balances in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to receivables from non-exchange transactions stated at R46,6 million (2014: R32,1 million) in the statement of financial position and note 6 to the financial statements was necessary.

Payables from exchange transactions

9. I was unable to obtain sufficient appropriate audit evidence regarding payables from exchange transactions, as the balances were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the balances in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to payables from exchange transactions stated at R178 million (2014: R42, 7 million) in the statement of financial position and note 16 to the financial statements was necessary.

Payables from non-exchange transactions

10. I was unable to obtain sufficient appropriate audit evidence regarding payables from non-exchange transactions, as the balances were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the balances in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to payables from non-exchange transactions stated at R32,7 million (2014: R26.7 million) in the statement of financial position and note 17 to the financial statements was necessary.

Inventory

11. I was unable to obtain sufficient appropriate audit evidence regarding inventory, as the balances were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the balances in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to inventory stated at R15,5 million (2014: R13,1 million) in the statement of financial position and note 3 to the financial statements was necessary.

Employee costs

12. I was unable to obtain sufficient appropriate audit evidence for employee costs, as internal controls had not been established for the recording of all employee costs from the payroll. I could not confirm whether all employee salaries had been recorded by alternative means. Consequently, I was unable to determine whether any adjustments to employee costs stated at R133 million (2014: R132, 9 million) in the statement of financial performance and note 28 to the financial statements was necessary.

Commitments

13. I was unable to obtain sufficient appropriate audit evidence regarding the commitments disclosure, as the commitments were presented in the financial statements for auditing purposes without accurate and complete underlying accounting records. I was unable to audit the disclosure in the financial statements by alternative means. Consequently, I was unable to determine whether any adjustments to commitments stated at R18, 8 million (2014: R67.7 million) in note 39 to the financial statements was necessary.

Irregular expenditure

14. The municipality did not disclose all irregular expenditure incurred during the year as they did not have adequate systems in place as required by section 125(2)(d)(i) of the MFMA . Due to the lack of systems it was impracticable to determine the full extent of the understatement of the irregular expenditure, and it was not possible to confirm this by alternative means. Consequently, I was unable to determine whether any further adjustments were necessary to the irregular expenditure disclosed in note 43 to the financial statements of R81,7 million (2014: R81,1 million).

Unauthorised expenditure

15. Sufficient appropriate audit evidence could not be obtained for unauthorised expenditure incurred in the prior years that are included in the current year closing balance. I was unable to confirm these amounts by alternative means. Consequently, I was unable to determine whether any adjustments were necessary to the current and prior year unauthorised expenditure of R225,2 million (2014: R193,4 million) as disclosed in note 41 to the financial statements.

Contingent liabilities

16. The municipality did not record all their contingent liabilities, which resulted in contingent liabilities being understated by R4,6 million. In addition, I was unable to obtain sufficient

appropriate audit evidence that all contingent liabilities had been recorded, as the municipality did not have adequate systems and processes in place and I could not confirm this by alternative means. Consequently, I was unable to determine whether any further adjustment to contingent liabilities stated at R49,9 million (2014: R1 million) in note 46 to the financial statements was necessary.

Heritage assets

17. The municipality did not assess whether there was an indication of impairment on heritage assets in accordance with GRAP 103: *Heritage Assets*. Therefore, I was unable to audit the recoverable amount disclosed in the financial statements by alternative means. Consequently, I was unable to determine the recoverable amount of heritage assets stated at R29 million (2014: R28.9 million) in the statement financial position and note 11 to the financial statements.

Cash flow statement

18. The presentation of the cash flow statement was not in accordance with GRAP 2: *Cash flow statements*. Cash generated by operations, purchase of property, plant and equipment and proceeds on disposal of fixed assets in the cash flow statement were incorrectly calculated. Consequently, the net decrease in cash and cash equivalents as disclosed on the cash flow statement is understated by R55, 9 million.

Corresponding figures

19. The auditor's report for the year ended 30 June 2014 contained a disclaimer of opinion on the financial statements as a whole due to a limitation on the scope of the audit. The matters and related amounts which gave rise to the limitation in the prior year, as described below, remain unresolved in the current year.

The municipality could not provide sufficient appropriate evidence regarding:

- Revenue from exchange transactions of R179,3 million as disclosed on the statement of financial performance.
- Revenue from non-exchange transactions of R162,5 million as disclosed on the statement of financial performance.
- Depreciation and amortisation of R36,7 million as disclosed in note 30
- Grants and subsidies paid of R22,2 million as disclosed in note 36
- General expenses of R46,5 million as disclosed in note 27
- Bulk purchases of R67,1 million as disclosed in note 37
- Investment property of R201,3 million as disclosed in note 12
- Unspent conditional grants and receipts of R20,3 million as disclosed in note 18
- VAT payable of R14,1 million as disclosed in note 19
- Bank overdraft of R15,5 million as disclosed in note 7
- Other financial liabilities of R54,1 million as disclosed in note 20
- Employee benefit obligation of R57,1 million as disclosed in note 21

- Accumulated surplus of R985,6 million as disclosed on the statement of financial position
- Provision of consumer debtors of R90,1 million as disclosed on the statement of financial position
- The cash flow statement as a whole and the related notes

I was unable to confirm or verify these amounts by alternative means and, as a result, could not confirm the accuracy, existence, valuation, completeness of or rights and obligations to the above amounts included in the corresponding figures or determine the impact, if any, on current year balances.

Aggregation of immaterial uncorrected misstatements in the corresponding figures

20. I was unable to obtain sufficient appropriate audit evidence due to individually immaterial amounts, but materially misstated as a whole. These amounts were unsubstantiated and I was unable to confirm the following elements making up the statement of financial performance, statement of financial position and notes to annual financial statements by alternative means:

- Receivables from exchange transactions amounting to R6,4 million
- Cash and cash equivalents amounting to R2 million
- Property, Plant and Equipment amounting to R3,7 million
- Intangible Assets amounting to R0,9 million
- Investments amounting to R0,2 million
- Consumer deposits amounting to R2,3 million
- Provisions amounting to R3,1 million
- Other financial liabilities amounting to R4 million
- Employee benefit obligation amounting to R9,7 million
- Other Non-Distributable Reserves amounting to R5,4 million
- Bank overdraft amounting to R0,7 million
- Councillors remuneration amounting to R8,3 million
- Impairment loss amounting to R5,2 million
- Finance costs amounting to R6,3 million
- Lease rentals on operating expenses amounting to R1,1 million
- Repairs and maintenance amounting to R12,8 million
- Contracted services amounting to R6,9 million
- Actuarial gains amounting to R6,4 million
- Fruitless and wasteful amounting to R1,1 million

Qualified opinion

21. In my opinion, except for the possible effects of the matters described in the basis for qualified opinion paragraphs, the financial statements present fairly, in all material respects, the financial position of the Makana Local Municipality as at 30 June 2015 and its financial performance and cash flows for the year then ended, in accordance with SA standards of GRAP and the requirements of the MFMA.

Emphasis of matters

22. I draw attention to the matters below. My opinion is not modified in respect of these matters.

Financial Sustainability

23. The accounting authority's report on page xx of the financial statements indicates that the accounting officer has reviewed the municipality's cash flow forecast for the year to June 30, 2015 and, in the light of this review and the current financial position, she is not satisfied that the municipality has or has access to adequate resources to continue in operational existence for the foreseeable future.

Material losses

24. As disclosed in note 5 to the financial statements, material losses to the amount of R20,5 million (2014: R7,1 million) were incurred as a result of debt impairment written off against allowance for impairment.
25. As disclosed in note 50 to the financial statements, the municipality incurred material losses relating to electricity of R31,1 million (2014: R40,4 million) due to the poor management of electricity connections and illegal electricity connections.

Restatement of corresponding figures

26. As disclosed in note 48 to the financial statements, the corresponding figures for 30 June 2014 have been restated as a result of errors discovered during 30 June 2015 in the financial statements of the municipality at, and for the year ended, 30 June 2015.

Significant uncertainties

27. With reference to note 46 to the financial statements, the municipality was the defendant in a number of lawsuits estimated at R50 million (2014: R1 million). The outcome of these lawsuits cannot be determined at present as litigation is still in progress.

Fruitless and wasteful expenditure

28. As disclosed in note 42 to the financial statements, fruitless and wasteful expenditure amounting to R5,8 million (2013-14: R0,8 million) was incurred by the municipality during the year ended 30 June 2015. This expenditure was as a result of interest paid on overdue payments.

Additional matters

29. I draw attention to the matters below. My opinion is not modified in respect of these matters.

Unaudited supplementary schedules

30. The supplementary information as set out on pages xxx to xxx does not form part the financial statements. We have not audited these schedules and accordingly we do not express an opinion thereon.

Unaudited disclosure notes

31. In terms of section 125(2)(e) of the MFMA the municipality is required to disclose particulars of non-compliance with this legislation. This disclosure requirement did not form part of the audit of the financial statements and accordingly I do not express an opinion thereon.

Report on other legal and regulatory requirements

32. In accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and the general notice issued in terms thereof, I have a responsibility to report findings on the reported performance information against predetermined objectives for selected development priorities presented in the annual performance report, compliance with legislation and internal control. The objective of my tests was to identify reportable findings as described under each subheading, but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

Predetermined objectives

33. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for the following selected development priority presented in the annual performance report of the municipality for the year ended 30 June 2015:
- Development priority 2: Basic services and infrastructure on pages xxx to xxx
34. I evaluated the reported performance information against the overall criteria of usefulness and reliability.
35. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned development priorities. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the National Treasury's *Framework for managing programme performance information* (FMPPi).
36. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
37. The material findings in respect of the selected development priorities are as follows:

Basic Services and Infrastructure

Usefulness of reported performance information

Consistency of objectives and targets

38. Section 41(c) of the Municipal Systems Act requires the integrated development plan to form the basis for the annual report, therefore requiring consistency of objectives, indicators and targets between planning and reporting documents. A total of 22% of the reported indicators and targets were not consistent with those in the approved service delivery and implementation plan. This was due to a lack of proper systems and processes around performance management within the municipality.

Measurability of indicators and targets

39. The FMPPI requires that performance indicator must be verifiable, meaning that it must be possible to validate the processes and systems that produced the indicator. A total of 43% of the indicators were not verifiable. This was due to a lack of proper systems and processes around performance management within the municipality.

Reliability of reported performance information

40. The FMPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. I was unable to obtain the information and explanations we considered necessary to satisfy ourselves as to the reliability of the reported performance information. This was due to limitations placed on the scope of our work due to the fact that the auditee could not provide sufficient appropriate evidence in support of the reported performance information.

Additional matter

41. I draw attention to the following matter

Achievement of planned targets

42. Refer to the annual performance report on pages xx to xx for information on the achievement of the planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information for the selected development priority reported in paragraphs 38 to 40 of this report.

Compliance with legislation

43. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My material findings on compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

Strategic planning and performance management

44. The performance management system did not provide for policies and procedures to take steps for improvement where performance targets were not met, as required by section 41 (1)(d) of the MSA.
45. The municipality did not establish mechanisms to monitor and review its performance management system, as required by section 40 of the MSA.
46. The KPIs set by the municipality did not include indicators on the percentage of households with access to basic levels of water, sanitation, electricity and solid waste as required by section 43(2) of the MSA and the Municipal planning and performance management regulation 10(a).
47. The annual performance report for the year under review did not include a comparison of the performance with set targets , comparison with the previous financial year and measures taken to improve performance as required by section 46 (1) (b) and (c) of the MSA.
48. The performance management system and related controls were inadequate as it did not describe and represent the processes of performance planning/ monitoring/ measurement/ review/ reporting/ improvement and how it is conducted, organised and managed, including determining the roles of the different role-players, as required by sections 38 of the MSA and regulation 7 of the Municipal planning and performance management regulations.

Audit committee

49. The audit committee did not advise the council on matters relating to internal financial control and internal audits, risk management, accounting policies, effective governance, performance management and performance evaluation as required by section 166(2)(a) of the MFMA.
50. The audit committee did not advise the council on matters relating to the adequacy, reliability and accuracy of financial reporting and information, as required by section 166(2)(a)(iv) of the Municipal Finance Management Act.
51. The audit committee did not advise the council on matters relating to compliance with legislation, as required by section 166(2)(a)(vii) of the Municipal Finance Management Act.
52. The audit committee did not review the municipality's performance management system and make recommendations to the council, as required by Municipal planning and performance management regulation 14(4)(a)(ii).

53. The audit committee did not review all the quarterly internal audit reports on performance measurement, as required by Municipal planning and performance management regulation 14(4)(a)(i).
54. The audit committee did not submit, at least twice during the financial year, an audit report on the review of the performance management system to the council, as required by Municipal planning and performance management regulation 14(4)(a)(iii).

Internal audit

55. The internal audit unit did not function as required by section 165(2) of the Municipal Finance Management Act, in that:
- it did not prepare a risk-based audit plan and an internal audit programme for the financial year under review,
 - it did not report to the audit committee on the implementation of the internal audit plan, and
 - it did not advise the accounting officer and or report to the audit committee on matters relating to risk and risk management.

Revenue management

56. An adequate management, accounting and information system which accounts for debtors was not in place, as required by section 64(2)(e) of the Municipal Finance Management Act.
57. An effective system of internal control for debtors was not in place, as required by section 64(2)(f) of the Municipal Finance Management Act.

Financial statements

58. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the Municipal Finance Management Act. Material misstatements identified by the auditors in the submitted financial statements were not adequately corrected and the supporting records could not be provided subsequently, which resulted in the financial statements receiving a qualified audit opinion.

Expenditure management

59. Money owed by the municipality was not always paid within 30 days or an agreed period, as required by section 65(2)(e) of the Municipal Finance Management Act.
60. Reasonable steps were not taken to prevent unauthorised expenditure, irregular expenditure and fruitless and wasteful expenditure, as required by section 62(1)(d) of the Municipal Finance Management Act.

Liability management

- 61. An adequate management, accounting and information system which accounts for liabilities was not in place, as required by section 63(2) (a) of the MFMA.
- 62. An effective system of internal control for liabilities was not in place, as required by section 63(2) (c) of the MFMA.

Procurement and contract management

- 63. Sufficient appropriate audit evidence could not be obtained that all contracts were awarded in accordance with the legislative requirements and a procurement process which is fair, equitable, transparent and competitive, as management could not provide the bidding documentations for audit purposes.
- 64. Goods and services with a transaction value of below R200 000 were procured without obtaining the required price quotations as required by SCM regulation 17(a) and (c).
- 65. The contract performance and monitoring measures and methods were insufficient to ensure effective contract management, as required by section 116(2) (c) of the MFMA.
- 66. Awards were made to providers who are in the service of other state institutions or whose directors/ principal shareholders are in the service of other state institutions, in contravention of MFMA 112(j) and SCM regulations 44. Similar awards were identified in the prior year and no effective steps were taken to prevent or combat the abuse of the SCM process in accordance with SCM regulation 38(1).
- 67. The performance of contractors or providers was not monitored on a monthly basis, as required by section 116(2) (b) of the MFMA.
- 68. Sufficient appropriate audit evidence could not be obtained that contracts were awarded only to bidders who submitted a declaration on whether they are employed by the state or connected to any person employed by the state, as required by SCM regulation 13(c).

Human resource management

- 69. The competencies of financial and SCM officials were not assessed in a timely manner in order to identify and address gaps in competency levels, as required by regulation 13 of the Municipal regulations on minimum competency levels.
- 70. An approved staff establishment was not in place, as required by section 66(1)(a) of the MSA.
- 71. The municipal manager and senior managers directly accountable to the municipal manager did not sign performance agreements, as required by section 57(2)(a) MSA.
- 72. The municipality did not submit a report on compliance with prescribed competency levels to the National Treasury and relevant provincial treasury as required by the Municipal Regulations on Minimum Competency Levels 14(2)(a) .

Consequence management

- 73. Unauthorised , Irregular, fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person is liable for the expenditure, as required by section 32(2)(a)(ii) of the Municipal Finance Management Act.
- 74. Unauthorised, irregular, fruitless and wasteful expenditure was not always recovered from the liable person, as required by section 32(2) of the Municipal Finance Management Act.

Internal control

- 75. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the qualified opinion, the findings on the annual performance report and the findings on compliance with legislation included in this report.

Leadership

- 76. Top and middle management positions were vacant for extended periods of time. The continued absence of permanent officials to lead and guide the municipality compromised the effectiveness of the control environment.
- 77. Leadership did not institute all the disciplines necessary to enable effective oversight that promoted efficiency and effectiveness in financial management, service delivery reporting and compliance with laws and regulations, thus not setting the correct tone for the credibility of all reports generated by the administration. This was evidenced by the material findings on the financial statements, annual performance information and compliance with laws and regulations.

Financial and performance management

- 78. The municipality did not fully implement and monitor all required daily and monthly financial and performance disciplines to ensure that transactions were appropriately recorded in line with GRAP and the FMPP. The lack of financial discipline and monitoring during the financial year resulted in key reconciliations and processing only being performed after the financial year-end. If not appropriately addressed by the municipality, this can impact the sustainability of the reported opinion.
- 79. There are no review processes in place to monitor compliance with all applicable laws and regulations within the municipality. As a result non-compliance with applicable laws and regulations is not effectively identified or prevented and municipal officials are not held accountable for any transgression in respect of this.

Governance

80. The internal audit unit was not effective in their review of internal controls and compliance with laws and regulations. This was largely as a result of the capacity constraints within the internal audit unit and the lack of co-operation from management.
81. As a result of the impaired functioning of the internal audit unit, the audit committee could not effectively evaluate and monitor responses to risks and provide effective guidance in respect of the internal control environment, including financial and performance reporting and compliance with laws and regulations.

Auditor-General

East London

30 November 2015



AUDITOR-GENERAL
SOUTH AFRICA

Auditing to build public confidence